

**EFFECTS OF
INCREASING THE HAWAII STANDARD DEDUCTION,
EXPANDING THE HAWAII INDIVIDUAL INCOME TAX BRACKETS,
AND
ENACTING A HAWAII EARNED INCOME TAX CREDIT AND
FOOD, MEDICAL SERVICES, AND NONPRESCRIPTION DRUG
INCOME TAX CREDIT**

Prepared by the Tax Research and Planning Office, Hawaii Department of Taxation

I. Introduction

The 2005-2007 Tax Review Commission requested a study of the potential revenue impact of four tax relief measures: (1) increase the Hawaii standard deduction to 75% of the federal standard deduction amounts, (2) expand the Hawaii individual income tax brackets by 25%, (3) enact an earned income tax credit equal to a percentage of the federal earned income tax credit, and (4) enact a food, medical services, and nonprescription drug income tax credit to mitigate the impact of the Hawaii general excise tax on those activities.

Act 110, Session Laws of Hawaii (SLH) 2006, partially adopted two of the tax relief measures included in this study. For taxable years beginning after December 31, 2006, the Hawaii standard deduction amounts increase to 40% of the 2005 federal standard deduction amounts and the individual income tax brackets expand by 20%. Bills proposing a Hawaii earned income tax credit and a food, medical services, and nonprescription drug income tax credit failed to pass in 2006.

This report discusses the revenue impact of each of the four tax relief measures as requested by the Commission and, with respect to the increase in the standard deduction and the expansion of the individual income tax brackets, as amended by Act 110, SLH 2006.

II. Increase the Standard Deduction to 75% of the 2005 Federal Amounts

The standard deduction is an income tax deduction that may, in most cases, be claimed in lieu of itemized deductions.¹ The higher the standard deduction, the lower the taxable income and the less tax owed. Because it is a fixed amount based on the taxpayers' filing status, claiming the standard deduction reduces the complexity of tax returns and relieves taxpayers of the burden of substantiating each itemized deduction claimed.

The standard deduction is also one factor used to determine if an individual must file a Hawaii income tax return. Individual taxpayers with total gross income less than their combined standard deduction and personal exemption are usually not required to file Hawaii income tax returns as they will have no State tax liability.² Therefore, increasing the standard deduction should, particularly for those with very low incomes, reduce the number of individuals with taxable income and who are therefore required to file a Hawaii income tax return.

Unlike the federal standard deduction amounts, which are indexed to inflation, the Hawaii standard deduction amounts are fixed by statute and were last increased by Act 321, SLH 1989, such that low-income taxpayers have fallen further and further behind. As noted by the 2001-2003 Tax Review Commission, failing to increase the standard deduction "is the major reason why the State unnecessarily continues to tax persons with income levels that qualify for public assistance."³

¹ Spouses of individuals who claim itemized deductions on separately filed returns and individuals who are classified as nonresident aliens or dual-status aliens of the United States are required to itemize their deductions and may not claim the standard deduction.

² There are other reasons why a taxpayer may be required to file a Hawaii return (e.g., persons doing business in Hawaii whether a net profit or loss is realized), and individuals who are not required to file a Hawaii income tax return may nonetheless continue to do so in order to claim various Hawaii refundable income tax credits for which they may be eligible (e.g., the low-income refundable tax credit and the low-income household renters credit).

³ State of Hawaii, *Report of the 2001 – 2003 Tax Review Commission*, (Honolulu, 2002) 15.

The Lingle-Aiona Administration proposed that the 2006 Legislature increase the Hawaii standard deduction to 75% of the 2005 federal standard deduction amounts. Act 110, SLH 2006, instead increased the Hawaii standard deduction amounts to only 40% of the 2005 federal standard deduction amounts for taxable years beginning after December 31, 2006.⁴ The current, proposed, and recently enacted standard deduction amounts are shown in Table 1 below.

TABLE 1: Standard Deduction Amounts

Filing Status	Current Hawaii Std. Deduction	2005 Federal Std. Deduction	75% of Federal Std. Deduction	40% of Federal Std. Deduction
Single	\$1,500	\$5,000	\$3,750	\$2,000
Married: Joint	1,900	10,000	7,500	4,000
Married: Separate	950	5,000	3,750	2,000
Head of Household	1,650	7,300	5,475	2,920
Qualifying Widow(er)	1,900	10,000	7,500	4,000

Increasing the Hawaii standard deduction amounts to a percentage of the 2005 federal standard deduction amounts also eliminates the State's "marriage penalty". The marriage penalty resulted because the standard deduction for a married couple was less than that for two single individuals. That is, a married couple's total standard deduction was \$1,900 whether filing joint or separate returns, whereas each would have been able to claim \$1,500 had they been unmarried, for a combined total of \$3,000.

Staff of the Tax Research and Planning Office prepared revenue impact assessments for increases in the Hawaii standard deduction to 75% and 40% of the 2005 federal standard deduction amounts, both of which are presented in Table 2. Also included in Table 2 are their estimates for changes in the number of returns deducting the standard deduction instead of itemized deductions and the number of returns filed that reflect a Hawaii income tax liability.

⁴ The standard deduction for individuals who can be claimed as a dependent is the greater of \$500 or the individual's earned income, but no more than the individual's eligible standard deduction (Act 239, SLH 1987). This provision was not amended by Act 110, SLH 2006, and remains unchanged.

TABLE 2: Effects of Increasing Hawaii Standard Deduction Amounts to a Percentage of the 2005 Federal Standard Deduction Amounts (Based on 2003 Tax Return Data)

	Current Hawaii Std. Deduction	75% of Federal Std. Deduction	40% of Federal Std. Deduction
Tax Liability Revenue Impact	\$1,022,791,403 N/A	\$980,884,972 -41,906,431	\$1,012,011,137 -10,780,266
Number of Returns Claiming Std. Deduction Change	244,661 N/A	343,407 98,746	282,374 37,713
Number of Returns Claiming Itemized Deduction Change	304,448 N/A	205,702 -98,746	266,735 -37,713
Number of Returns With Hawaii Tax Liability Change	472,628 N/A	432,257 -40,371	462,098 -10,530

III. Expand Hawaii's Income Tax Brackets By 25%

Hawaii's graduated individual income tax rate brackets, like the standard deduction amounts, are fixed by statute rather than indexed to inflation and were last changed by Act 157, SLH 1998. Further expansion of the existing tax rate brackets would benefit all individual taxpayers with taxable income. Lower-income taxpayers would be able to earn more income without moving into the higher tax rate brackets, and higher-income taxpayers would have more of their income taxed at the lower tax rates.

Act 110, SLH 2006, expanded the individual income tax brackets by 20% for taxable years beginning after December 31, 2006. The current Hawaii tax rate schedules, as well as the tax rate schedules for a 25% expansion and the 20% expansion enacted by Act 110, SLH 2006, are provided in Attachment 1.

Staff of the Tax Research and Planning Office prepared revenue impact assessments for an expansion of Hawaii's income tax brackets by 25% and 20%, both of which are presented in Table 3 below.

TABLE 3: Revenue Impact of Expanding Hawaii Individual Income Tax Brackets (Based on 2003 Tax Return Data)

	Current	25% Expansion	20% Expansion
Tax Liability	\$1,022,791,403	\$976,009,314	\$984,823,314
Revenue Impact	N/A	-46,782,089	-37,968,089

IV. Enact a Hawaii Earned Income Tax Credit

Legislation for a refundable Hawaii earned income tax credit for Hawaii resident taxpayers equal to 20% of the federal earned income tax credit failed to be enacted in 2006.

The staff of the Tax Research and Planning Office estimated the number of returns on which this credit could have been claimed based on returns filed for tax year 2003 by taxpayers who were Hawaii residents for the entire year,⁵ excluding returns filed by individuals who could be claimed as a dependent by another taxpayer.

As shown in Table 4 below, fewer than half of the Hawaii resident income tax returns filed would have benefited from a Hawaii earned income tax credit, even amongst the lowest income categories. Of the 308,652 Hawaii returns reporting Hawaii adjusted gross income of less than \$30,000, only 68,845 or 22.3% claimed the earned income tax credit on their federal income tax returns.

The low number of filers with low Hawaii adjusted gross incomes who also claim the federal earned income tax credit may in part be attributable to returns filed by taxpayers with little or no earned income but who nonetheless file a Hawaii income tax return to claim refundable income tax credits available to qualifying taxpayers with low or no income.

⁵ Data on federal earned income tax credits claimed by part-year Hawaii residents was not available.

TABLE 4: Resident Returns Filed by Taxpayers Who Also Claimed the Federal Earned Income Tax Credit on Their Federal Income Tax Returns (Source: Hawaii Income Patterns – Individuals 2003)

Hawaii Adjusted Gross Income Class	Number of Hawaii Resident Returns Filed	Number Also Claiming the Federal Earned Income Tax Credit	Percent of Hawaii Resident Returns Filed
Under \$5,000	101,318	11,967	11.8%
\$5,000 " \$20,000	50,323	16,139	32.1%
\$10,000 " \$20,000	83,572	22,073	26.4%
\$20,000 " \$30,000	73,439	18,666	25.4%
\$30,000 " \$40,000	53,163	3,562	6.7%
\$40,000 " \$50,000	37,413	63	0.2%
\$50,000 " \$75,000	60,259	31	0.1%
\$75,000 " \$100,000	32,237	10	0.0%
\$100,000 " \$150,000	22,417	0	0.0%
\$150,000 " \$200,000	5,771	0	0.0%
\$200,000 and Over	6,604	0	0.0%
TOTAL	526,516	72,511	13.8%

Based on the amount of federal earned income tax credit claimed, the staff of the Tax Research and Planning Office computed a \$23.2 million decline in tax collections should a Hawaii earned income tax credit equal to 20% of the federal earned income tax credit be enacted. See Table 5 below for detailed information.

Unconfirmed language in at least two bills proposing an earned income credit during the 2006 legislative session⁶ indicated that the amount of tax revenue foregone by the State for Hawaii earned income tax credit claims would be reimbursed by federal Temporary Assistance for Needy Families (TANF) funds or State TANF Maintenance of Effort funds. If this is so, the

⁶ H.B. 2018 and H.B. 3228

estimated cost of this credit may not be fully borne by the State. However, a future reimbursement of the amount expended by the State for this credit would not impact State tax collections.

TABLE 5: Revenue Impact of a Hawaii Earned Income Tax Credit of 20% of the Federal Earned Income Tax Credit (Based on 2003 Tax Return Data)

Hawaii Adjusted Gross Income Class	Federal Earned Income Tax Credit Claimed	20% Hawaii Earned Income Tax Credit
Under \$5,000	\$7,377,643	\$1,475,529
\$5,000 " \$20,000	\$22,803,515	\$4,560,703
\$10,000 " \$20,000	\$58,851,817	\$11,770,363
\$20,000 " \$30,000	\$24,832,577	\$4,966,515
\$30,000 " \$40,000	\$1,927,270	\$385,454
\$40,000 " \$50,000	\$16,384	\$3,277
\$50,000 " \$75,000	\$9,497	\$1,899
\$75,000 " \$100,000	\$41,400	\$8,280
TOTAL	\$115,860,103	\$23,172,020

V. Enact a Hawaii Food, Medical Services, and Nonprescription Drug Income Tax Credit

Various food and medical income tax credits have been enacted from time to time,⁷ usually to mitigate the effects of the 4% Hawaii general excise tax on food, medical services, and nonprescription drugs passed on by retailers to Hawaii resident consumers.⁸

⁷ For more information, see the *Tax Credits Claimed by Hawaii Residents* report published annually by the Department of Taxation's Tax Research and Planning Office, which is available on the Department's website at www.hawaii.gov/tax.

⁸ Food purchased with United States Department of Agriculture food coupons under either the food stamp program or the Special Supplemental Foods Program for Women, Infants, and Children are exempt from the general excise tax under §237-24.3(6), Hawaii Revised Statutes (HRS). Medical services provided by tax-exempt hospitals and other tax-exempt medical facilities are generally exempt from the general excise tax under §237-23, HRS. Sales of prescription drugs and prosthetic devices are exempt from the general excise tax under §237-24.3(7), HRS.

In 2006, the Lingle-Aiona Administration proposed legislation to establish a refundable income tax credit that would have been known as the Working Families' Tax Credit for Food, Medical Services, and Nonprescription Drugs.

Although it did not pass, the proposed Working Families' Tax Credit for Food, Medical Services, and Nonprescription Drugs would have been \$100 per qualified exemption for Hawaii resident individual taxpayers with federal adjusted gross income of \$50,000 or less.⁹ It would not have been available to taxpayers with no income or no income subject to Hawaii income tax because, as stated in the proposed bills, the credit was intended "to provide economic relief for struggling working families."

The bill also proposed using federal adjusted gross income, rather than Hawaii adjusted gross income, to determine eligibility for the credit in part because differences between Hawaii and federal income taxes (e.g., Hawaii's exemption for qualifying government pension distributions and certain non-government pension distributions attributable to employer contributions and received upon retirement, death, or disability) could have resulted in a relatively high-income taxpayer qualifying for this credit had the Hawaii adjusted gross income been used.

Staff of the Tax Research and Planning Office estimated that the revenue impact of this credit for fiscal year 2007 would have been \$70.7 million (excluding returns filed by individuals who could be claimed as a dependent by another taxpayer). Details of their estimates are presented in Table 6 below.

⁹ H.B 2415 and S.B. 2378.

TABLE 6: Revenue Impact of the Working Families' Tax Credit for Food, Medical Services, and Nonprescription Drugs for Fiscal Year 2007 (Based on 2003 Tax Return Data for Resident Individual Taxpayers With Federal Adjusted Gross Income of Less Than \$50,000)

Federal Adjusted Gross Income	Total Exemptions	\$100 Per Exemption (Cumulative)
Under \$5,000	175,560	\$17,556,000
\$5,000 but less than \$10,000	57,566	23,312,600
\$10,000 but less than \$20,000	139,059	37,218,500
\$20,000 but less than \$30,000	135,530	50,771,500
\$30,000 but less than \$40,000	107,228	61,494,300
\$40,000 but less than \$50,000	91,617	70,656,000
DHS w/Federal AGI over \$50,000*	154	70,671,400

* Represents children who cannot be claimed as dependents because they receive more than half their support from the Department of Human Services (DHS), social security survivors' benefits, and the like, but who are considered qualified exemptions for certain credits (e.g., the low-income refundable tax credit) only.

The anomaly in the last line of Table 6 should not occur under current law. Hawaii conformed to federal law regarding a change in the definition of a qualified child dependent,¹⁰ such that a child who receives more than half his or her support from the Department of Human Services, Social Security Survivor's Benefits, and the like, may be eligible in most cases to be claimed as a dependent by their parent or guardian.

¹⁰ Act 60, SLH 2005.

ATTACHMENT 1

TAX RATE SCHEDULES

Schedule 1: Hawaii Tax Rate Schedule
Current

Schedule 2: Hawaii Tax Rate Schedule
20% Tax Bracket Expansion

Schedule 3: Hawaii Tax Rate Schedule
25% Tax Bracket Expansion

SCHEDULE 1: Hawaii Tax Rate Schedule – Current

A. SINGLE OR MARRIED FILING SEPARATELY	
<i>If the taxable income is</i>	<i>The tax shall be</i>
Not over \$2,000	1.40% of taxable income
Over \$2,000 but not over \$4,000	\$ 28 plus 3.20% over \$2,000
Over \$4,000 but not over \$8,000	\$ 92 plus 5.50% over \$4,000
Over \$8,000 but not over \$12,000	\$ 312 plus 6.40% over \$8,000
Over \$12,000 but not over \$16,000	\$ 568 plus 6.80% over \$12,000
Over \$16,000 but not over \$20,000	\$ 840 plus 7.20% over \$16,000
Over \$20,000 but not over \$30,000	\$ 1,128 plus 7.60% over \$20,000
Over \$30,000 but not over \$40,000	\$ 1,888 plus 7.90% over \$30,000
Over \$40,000	\$ 2,678 plus 8.25% over \$40,000
B. JOINT AND QUALIFIED WIDOWS	
<i>If the taxable income is</i>	<i>The tax shall be</i>
Not over \$4,000	1.40% of taxable income
Over \$4,000 but not over \$8,000	\$ 56 plus 3.20% over \$4,000
Over \$8,000 but not over \$16,000	\$ 184 plus 5.50% over \$8,000
Over \$16,000 but not over \$24,000	\$ 624 plus 6.40% over \$16,000
Over \$24,000 but not over \$32,000	\$ 1,136 plus 6.80% over \$24,000
Over \$32,000 but not over \$40,000	\$ 1,680 plus 7.20% over \$32,000
Over \$40,000 but not over \$60,000	\$ 2,256 plus 7.60% over \$40,000
Over \$60,000 but not over \$80,000	\$ 3,776 plus 7.90% over \$60,000
Over \$80,000	\$ 5,356 plus 8.25% over \$80,000
C. HEAD OF HOUSEHOLD	
<i>If the taxable income is</i>	<i>The tax shall be</i>
Not over \$3,000	1.40% of taxable income
Over \$3,000 but not over \$6,000	\$ 42 plus 3.20% over \$3,000
Over \$6,000 but not over \$12,000	\$ 138 plus 5.50% over \$6,000
Over \$12,000 but not over \$18,000	\$ 468 plus 6.40% over \$12,000
Over \$18,000 but not over \$24,000	\$ 852 plus 6.80% over \$18,000
Over \$24,000 but not over \$30,000	\$ 1,260 plus 7.20% over \$24,000
Over \$30,000 but not over \$45,000	\$ 1,692 plus 7.60% over \$30,000
Over \$45,000 but not over \$60,000	\$ 2,832 plus 7.90% over \$45,000
Over \$60,000	\$ 4,017 plus 8.25% over \$60,000

SCHEDULE 2: Hawaii Tax Rate Schedule – 20% Tax Bracket Expansion**A. SINGLE OR MARRIED FILING SEPARATELY**

<i>If the taxable income is</i>	<i>The tax shall be</i>
Not over \$2,400	1.40% of taxable income
Over \$2,400 but not over \$4,800	\$34 plus 3.20% over \$2,400
Over \$4,800 but not over \$9,600	\$110 plus 5.50% over \$4,800
Over \$9,600 but not over \$14,400	\$374 plus 6.40% over \$9,600
Over \$14,400 but not over \$19,200	\$682 plus 6.80% over \$14,400
Over \$19,200 but not over \$24,000	\$1,008 plus 7.20% over \$19,200
Over \$24,000 but not over \$36,000	\$1,354 plus 7.60% over \$24,000
Over \$36,000 but not over \$48,000	\$2,266 plus 7.90% over \$36,000
Over \$48,000	\$3,214 plus 8.25% over \$48,000

B. JOINT AND QUALIFIED WIDOWS

<i>If the taxable income is</i>	<i>The tax shall be</i>
Not over \$4,800	1.40% of taxable income
Over \$4,800 but not over \$9,600	\$67 plus 3.20% over \$4,800
Over \$9,600 but not over \$19,200	\$221 plus 5.50% over \$9,600
Over \$19,200 but not over \$28,800	\$749 plus 6.40% over \$19,200
Over \$28,800 but not over \$38,400	\$1,363 plus 6.80% over \$28,800
Over \$38,400 but not over \$48,000	\$2,016 plus 7.20% over \$38,400
Over \$48,000 but not over \$72,000	\$2,707 plus 7.60% over \$48,000
Over \$72,000 but not over \$96,000	\$4,531 plus 7.90% over \$72,000
Over \$96,000	\$6,427 plus 8.25% over \$96,000

C. HEAD OF HOUSEHOLD

<i>If the taxable income is</i>	<i>The tax shall be</i>
Not over \$3,600	1.40% of taxable income
Over \$3,600 but not over \$7,200	\$50 plus 3.20% over \$3,600
Over \$7,200 but not over \$14,400	\$166 plus 5.50% over \$7,200
Over \$14,400 but not over \$21,600	\$562 plus 6.40% over \$14,400
Over \$21,600 but not over \$28,800	\$1,022 plus 6.80% over \$21,600
Over \$28,800 but not over \$36,000	\$1,512 plus 7.20% over \$28,800
Over \$36,000 but not over \$54,000	\$2,030 plus 7.60% over \$36,000
Over \$54,000 but not over \$72,000	\$3,398 plus 7.90% over \$54,000
Over \$72,000	\$4,820 plus 8.25% over \$72,000

SCHEDULE 3: Hawaii Tax Rate Schedule – 25% Tax Bracket Expansion

A. SINGLE OR MARRIED FILING SEPARATELY	
<i>If the taxable income is</i>	<i>The tax shall be</i>
Not Over \$2,500	1.40% of taxable income
Over \$2,500 but not over \$5,000	\$35 plus 3.20% of excess over \$2,500
Over \$5,000 but not over \$10,000	\$115 plus 5.50% of excess over \$5,000
Over \$10,000 but not over \$15,000	\$390 plus 6.40% of excess over \$10,000
Over \$15,000 but not over \$20,000	\$710 plus 6.80% of excess over \$15,000
Over \$20,000 but not over \$25,000	\$1,050 plus 7.20% of excess over \$20,000
Over \$25,000 but not over \$37,500	\$1,410 plus 7.60% of excess over \$25,000
Over \$37,500 but not over \$50,000	\$2,360 plus 7.90% of excess over \$37,500
Over \$50,000	\$3,348 plus 8.25% of excess over \$50,000
B. JOINT AND QUALIFIED WIDOWS	
<i>If the taxable income is</i>	<i>The tax shall be</i>
Not Over \$5,000	1.40% of taxable income
Over \$5,000 but not over \$10,000	\$70 plus 3.20% of excess over \$5,000
Over \$10,000 but not over \$20,000	\$230 plus 5.50% of excess over \$10,000
Over \$20,000 but not over \$30,000	\$780 plus 6.40% of excess over \$20,000
Over \$30,000 but not over \$40,000	\$1,420 plus 6.80% of excess over \$30,000
Over \$40,000 but not over \$50,000	\$2,100 plus 7.20% of excess over \$40,000
Over \$50,000 but not over \$75,000	\$2,820 plus 7.60% of excess over \$50,000
Over \$75,000 but not over \$100,000	\$4,720 plus 7.90% of excess over \$75,000
Over \$100,000	\$6,695 plus 8.25% of excess over \$100,000
C. HEAD OF HOUSEHOLD	
<i>If the taxable income is</i>	<i>The tax shall be</i>
Not Over \$3,750	1.40% of taxable income
Over \$3,750 but not over \$7,500	\$53 plus 3.20% of excess over \$3,750
Over \$7,500 but not over \$15,000	\$173 plus 5.50% of excess over \$7,500
Over \$15,000 but not over \$22,500	\$585 plus 6.40% of excess over \$15,000
Over \$22,500 but not over \$30,000	\$1,065 plus 6.80% of excess over \$22,500
Over \$30,000 but not over \$37,500	\$1,575 plus 7.20% of excess over \$30,000
Over \$37,500 but not over \$56,250	\$2,115 plus 7.60% of excess over \$37,500
Over \$56,250 but not over \$75,000	\$3,540 plus 7.90% of excess over \$56,250
Over \$75,000	\$5,021 plus 8.25% of excess over \$75,000